UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 03-1448

Donald G. Oren and Beverly J. Oren,

Appellants,

vs.

Commissioner of Internal Revenue,

Appellee.

ON APPEAL FROM THE UNITED STATES TAX COURT

REPLY BRIEF FOR THE APPELLANTS DONALD G. OREN AND BEVERLY J. OREN

Myron L. Frans
Faegre & Benson LLP
2200 Wells Fargo Center
90 South Seventh Street
Minneapolis, Minnesota 55402-3901
(612) 766-6906

Attorney for Appellants

TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES

CASES

Page

INTERNAL REVENUE CODE

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 03-1448

Donald G. Oren and Beverly J. Oren,

Appellants,

vs.

Commissioner of Internal Revenue,

Appellee.

INTRODUCTION

Congress enacted procedures that allow a shareholder to deduct losses from an S corporation. These procedures limit shareholder deductions of S corporation losses in two situations relevant to this case. First, loss deductions are limited to the extent of a shareholder's investment in an S corporation, in this case, an S corporation indebtedness to a shareholder. I.R.C. § 1366(d)[1] (relevant portions at Add. 39a)[2]. Second, loss deductions

---

[1] All references to the Internal Revenue Code and the Treasury Regulations shall be to the 1986 Code, as amended, and the Treasury Regulations promulgated thereunder, hereafter I.R.C. or Code.

[2] "Add." references are to the Addendum bound with Appellants' Brief. "App." references are to Appellants' separately-bound Appendix.

are limited to the extent a shareholder is at risk on amounts that he borrows and then contributes to a business activity, in this case leasing.

I.R.C. § 465(b) (relevant portions at Add. 38a).

Don Oren executed a series of lending transactions in which he made investments in Highway Leasing Company ("HL") and Highway Sales, Inc. ("HS") by transferring cash to them in exchange for recourse notes. Don Oren legally borrowed these funds from a related entity, Dart (with minority shareholders). What the Commissioner proposes, and the Tax Court erroneously adopted below, is to take Don Oren's sequence of perfectly legal acts and treat them as a sham, devoid of any economic substance. But here the Tax Court has gone too far. The Tax Court's unsound legal reasoning is based solely on the theory that Don Oren's investments in HL and HS constituted a tax scheme, which in turn is based primarily on a single fact, circularity of funds between related parties.

The record below, however, demonstrates that Don Oren completed the series of lending transactions in a perfectly legal manner. Don Oren's lending transactions had been carefully planned under the law to take advantage of permissible deductions based on his investments as a shareholder in HL and HS. Don Oren planned and executed his transactions

consistently with the intent of the statutes by investing in HL and HS, and by remaining personally liable on his loans from Dart.

None of the cases cited by the Tax Court support such a drastic departure from this Court's obligation to respect the plain language of the statutes in question. The Orens submit that no court has previously reviewed facts that so clearly satisfy both the form and substance of section 1366 and section 465. Furthermore, the Orens submit that the facts of this case are clearly distinguishable from those cases cited by the Commissioner and the Tax Court.

The Tax Court below erroneously adopted the Commissioner's view that the circular flow of funds between related parties fatally infected the lending transactions. Thus, even though the form of Oren's lending transactions was clearly reported and executed without defect, the intended result was nullified by the Tax Court. The Orens submit that the lending transactions, if viewed fairly, were genuine, had economic substance, were respected by the parties and were recognized as valid by independent third parties at the time of the lending transactions.

These last few points, in particular, cannot be found in any case cited by the Commissioner. Here, the lending transactions (1) were approved by First Bank (the lending bank) to Dart, HL, HS and their related companies;

(2) were respected by minority shareholders, who were active managers with economic interests that differed from Don Oren; and (3) were recognized by independent auditors, who reported their results in audited Combined Financial Statements each year in question. The Orens case is compelling on its facts because of the volume of favorable factors in the record.

I. DON OREN CORRECTLY STRUCTURED HIS FOUR DIRECT SHAREHOLDER LOANS TO COMPLY WITH SECTION 1366, AND THEREFORE PROPERLY INCREASED HIS TAX BASIS IN HIGHWAY LEASING ("HL") AND HIGHWAY SALES ("HS").

The plain language of section 1366 provides the rules for determining a shareholder's adjusted basis in an S corporation. Section 1366 expressly limits a shareholder's deduction of losses in an S corporation to a shareholder's adjusted basis in stock and debt. A shareholder's adjusted basis in debt is based on the direct indebtedness of the S corporation to a shareholder. Don Oren's four direct shareholder loans to HL and HS satisfies the plain language of section 1366 and his direct transfer of cash to HL and HS satisfies the often misinterpreted, and inconsistently applied, economic outlay requirement.

The Commissioner's Brief ("Comm. Br.") fails to provide any factual challenge to the structure of Don Oren's loans to HL and HS, two S corporations owned by Don Oren. Why? Because Don Oren's four direct

shareholder loans were specifically structured to, and did, conform to section 1366. Why? Because the plain language of section 1366 requires direct S corporate indebtedness to its shareholders to qualify for increases in adjusted tax basis. Don Oren intended to increase his adjusted tax basis in HL and HS by directly loaning them funds. Add. 8a. He complied with the statutory requirements and should be entitled to benefits of section 1366.

The plain language of section 1366 must be respected. This simple legal principle comes from the Supreme Court. See Gitlitz v. Commissioner, 531 U.S. 206, 215-16 (2001). The Gitlitz case was decided only two years ago. The Court was asked to analyze the proper treatment of "items of income" under section 1366(a). The Commissioner instructs this Court, in a mere footnote, that Gitlitz is inapposite because the case involves subsection (a) rather than subsection (d) of section 1366. Comm. Br. 49-50 n.11. Despite the Commissioner's compelling argument to the contrary, the Orens assert that the relevant legal principle from the Supreme Court in Gitlitz is that benefits provided directly by the plain language of a statute must be respected, even in cases where a windfall will go to the taxpayer. Id. at 220. There is no potential windfall here. Congress enacted procedures for shareholders to increase their adjusted basis in S corporations under section 1366 and that procedure must be respected.

The cases cited by the Commissioner involve fact patterns in which shareholders of S corporations belatedly attempt to comply with section 1366 by recasting a transaction "as if" they had made the loans (when they did not), or by rearranging loans after the original cash was loaned by some one or some entity other than the shareholder. These cases have no application to the facts at issue here because Don Oren is not trying to recast or rearrange any loans. He made direct loans to HL and HS, and thus fully complied with section 1366. The Commissioner has failed to provide any legal support that justifies ignoring the plain language of section 1366.

The Tax Court erred as a matter of law in its application of section 1366 and it decision should be reversed. The Tax Court's error is subject to de novo review. Wal-Mart Stores v. Commissioner, 153 F.3d 650, 657 (8th Cir. 1998).

A. The Commissioner Conceded that Oren Satisfied the Statutory Requirements of Section 1366.

The Commissioner's "characterization" of the factual components of the lending transactions at issue here is: they served only as a more elaborate subterfuge than the offsetting bookkeeping entries that failed to qualify as creating tax basis in other cases. Comm. Br. 41 (citing Griffith v. Commissioner, 56 T.C.M. (CCH) 220 (1988); Burnstein v. Commissioner,

47 T.C.M. (CCH) 1100 (1984)). Likewise, the Tax Court adopted the Commissioner's argument below and "labeled" Don Oren as "a mere conduit among Dart, HL, and HS." Add. 28a-29a.

The Commissioner's "characterization" and the Tax Court's "labeling" is directly contrary to the record. The Commissioner failed to refute the overwhelming evidence in the record that the lending transactions were properly structured under section 1366 and were properly executed. Both the Commissioner and the Tax Court ignored or misinterpreted the facts and instead they simply labeled the transaction as circular, over and over and over again (30 times by the Commissioner). Blithely applying labels does not constitute legal analysis of the lending transactions.

The Orens submit that if the lending transactions are actually and fairly analyzed, they will be sustained as valid loans with economic substance. The following list, from the record, demonstrates the genuineness of the lending transactions:

1. All parties executed written notes for each loan contemporaneously with the transfer of funds. Add. 8a-12a.

2. All the notes were unconditional, legally enforceable, contained a specific interest charge and provided a repayment procedure. Add 8a-12a.

3. All parties transferred funds by checks written on appropriate accounts, and from different banks for some parties. Add 8a-12a.

4. All parties intended to repay the loans at time of each loan. App. 110.

5. All parties had the financial means to repay the loans (at time of each loan and during the term of the loans). Add. 3a, 5a, 6a, 8a n.3; App. 93.

6. All parties paid interest annually by checks written on appropriate accounts in 1994, 1995 and 1996, and in some cases on different banks. Add. 14a-15a.

7. All parties repaid the loans in 1996. Add. 15a-16a.

8. First Bank provided a line of credit to Dart, HL and HS, was aware of the loans and was aware that none of the loans violated the banking agreement. Add. 7a.

9. Pursuant to generally accepted auditing standards, Deloitte & Touche audited the Combined Financial Statements of Dart, HL and HS (and other related entities) for 1993, 1994 and 1995. App. 166-211 (see App. 168, 184 and 199 for a description of the methodology used to complete the Independent Auditors' Report).

10. Pursuant to generally accepted auditing standards, Deloitte & Touche audited and listed the lending transactions on the Combined (or

Combining for 1994 and 1995) Schedule of Balance Sheet Information for 1993, 1994 and 1995. App. 180, 195 and 210; Add. 12a-13a nn.5-6.

11. Deloitte & Touche offset the lending transactions for purposes of the Combined Balance Sheet pursuant to generally accepted accounting principles for 1993, 1994 and 1995. Add. 13a-14a n.7; App. 169, 185 and 200.

In summary, all the parties respected the lending transactions consistently with its unambiguous documentation, from its inception in 1993 until its repayment in 1996. The lending transactions were genuine and were consistent with the purpose of the statutes in question. See Knetsch v. United States, 364 U.S. 361 (1960). The requirements of section 1366 were clearly satisfied. Don Oren's four direct shareholder loans in 1993, 1994 and 1995 created additional tax basis in HL and HS.

B. The Financial Reporting of the Lending Transactions Was Clearly Reflected.

In addition to all the facts listed above that show the genuineness of the various loans, three independent parties had an interest in the loans. Each of the parties was aware of the loans and each had an opportunity or duty to review the loans independently of Don Oren: (1) First Bank, the lending bank, (2) Deloitte & Touche, the independent auditors and (3) Beverly Oren,

David Oren, Daniel Oren, Bradley Oren and Angela Oren, the minority shareholders of Dart.[3]

The independent auditors, Deloitte & Touche, audited the Combined Financial Statements ("Financial Statements") of Dart, HL, HS and other related entities in 1993, 1994 and 1995. The Commissioner stipulated to the admission of the Financial Statements without any objections. Deloitte & Touche audited and listed the lending transactions at issue in the Financial Statements. The Tax Court included portions of the Financial Statements in its opinion. Add. 12a-14a nn.5-7, 28a-29a n.19. The Tax Court, however, misinterpreted them. By his stipulation the Commissioner has conceded that the Financial Statements are relevant and fairly represent the financial aspects of the various companies included.

Deloitte & Touche reviewed and listed the lending transactions at issue all according to generally accepted auditing principles. For example, in 1993, Dart loaned $4,000,000 to Don Oren, Don Oren loaned $4,000,000 to HL and HL loaned $4,000,000 to Dart. The Combined Balance Sheet eliminated the offsetting loan obligations pursuant to Accounting Research Bulletin No. 51. App. 258-65. The Tax Court acknowledged the explanation

[3] All the minority shareholders, except Angela Oren who was a minor at the time, were active managers in the Dart companies during the years at issue.

of the offsets by the Bulletin, which was also stipulated by the Commissioner, without any objections. Add.13a-14a n.7.

In each of the Financial Statements for 1993, 1994 and 1995, the various related companies are represented individually in a schedule. In these later schedules, the lending transactions are listed for each company. Add. 180, 195 and 210. For 1993, the Combined Schedule of Balance Sheet Information (App. 180) shows that Dart had Notes Receivable – Affiliate of $5,901,000. $4,000,000 of this amount represented the loan to Don Oren. By looking down that same Dart column, the schedule shows that Dart had a Notes Payable – Affiliate of $4,000,000. This note was owed to HL by Dart. By looking at the column for HL, the schedule shows that HL had a $4,000,000 Notes Receivable – Affiliate. This note was owed to HL by Dart. By looking down that same column, the schedule shows that HL had a $4,000,000 Notes Payable – Affiliate. This note was owed to Don Oren by HL. The listing of the notes due to and from affiliates conforms to generally accepted auditing principles.

These schedules showed all notes receivable and payable in 1993 for Dart and HL. The loan made in 1993 by Don Oren to HL was clearly reported. The same procedure was followed in 1994 by Deloitte & Touche. The Commissioner has not placed in evidence any auditing principle that

requires listing to whom the payable was owed or from whom the note receivable was due (because there is no such auditing requirement).

In 1995, a change was made in the format, not the substance, of the Combining Schedule of Balance Sheet Information (App. 210). The Notes Payable and Receivable to affiliates were grouped under one category: Notes Payable (either as a positive number, due to; or a negative number, due from). That category was appropriately listed under Liabilities and Stockholders' Equity and it was separated into two categories: Notes Payable - Stockholder and Notes Payable - Affiliate. By looking at the Notes Payable – Stockholder line it is clear that the Stockholder (Don Oren) owed $15,300,000 to Dart; HS owed the Stockholder (Don Oren) $2,000,000; HL owed the Stockholder (Don Oren) $13,500,000. Or, in total, HL and HS owed Don Oren $15,500,000 and Don Oren owed Dart $15,300,000. This line shows Don Oren's cash contribution of $200,000. The loans made in 1993, 1994 and 1995 were clearly reported.

No reported case by the Commissioner provides this level of scrutiny for related party loans. The Financial Statements were the critical documents for purposes of the bank and any outside parties. The Commissioner's failure to challenge any aspect of the Financial Statements by his stipulation is a concession that the loans were audited and approved as genuine by the

auditors. No other explanation can now be made as to their listing on the Financial Statements.

In the preparation of Don Oren's personal financial statements the related party loans were eliminated in the calculation of his net worth under similar accounting principles as detailed in Accounting Research Bulletin No. 51. App. 258-65. Additionally, both the Tax Court and the Commissioner ignored Don Oren's testimony on cross-examination that he prepared his personal financial statements for estate planning purposes and he shared those statements only with his estate planner. App. 112. The Commissioner never challenged that statement at trial nor did he introduce any evidence to the contrary. The complaint that Don Oren did not list the lending transactions on his personal financial statements misses the point of preparing the personal financial statements. For estate planning purposes, Don Oren's net worth is relevant. For purposes of establishing net worth, the loans at issue offset one another. Complaints about the lack of loan disclosures on Don Oren's personal financial statements also ignore that the relevant loan disclosures were made in the Financial Statements for the Dart companies.

Not only were the lending transactions subject to scrutiny by independent parties, but the presence of minority shareholders in Dart

significantly distinguishes the legal stature of Dart as a related party from the reported cases. The Commissioner conceded that the Dart minority shareholders had legal rights to enforce the loans from Dart under state law, but described the significance of such legal rights as "overblown." Comm. Br. 52. The Tax Court also recognized the ownership and state law rights of the Dart minority shareholders, but simply chose to ignore them as meaningless. Add. 26a-27a n.17. Clearly the Dart minority shareholders had rights to protect their economic interests under state law. For the Tax Court to dismiss such rights as legally insignificant is clear error. The Dart minority shareholders respected the lending transactions and they had different economic interests than Don Oren.

Don Oren intended to loan funds to HL and HS. He made the loans and he reported the loans. Deloitte & Touche audited the lending transactions. First Bank and the Dart minority shareholders were aware of and had access to the audited Financial Statements which listed the lending transactions. The lending transactions were clearly reported as intended.

C. Section 1366 Does Not Restrict a Shareholder's Use of Related Party Funds.

This Court had occasion to review a related party loan made to a shareholder who then purportedly loaned the money to his S corporation for purposes of increasing his adjusted basis pursuant to section 1366. See

Bergman v. United States, 174 F.3d 928 (8th Cir. 1999), rev'g and remanding, No. 3-96-850 (D. Minn. Dec. 19, 1997). In review of Bergman, this Court stated the general rule: "It is possible for a loan made as part of a loan restructuring to create additional basis under § 1366(d) since any genuineness indebtedness adds basis." Id. at 933 (emphasis added) (citing Gilday v. Commissioner, 42 T.C.M. (CCH) 1295 (1985)).

The problem for Bergman, unlike this case, was that the facts were disputed as to whether his loans were genuine. Furthermore, Bergman was a belated attempt to rearrange the original loan from one S corporation to another S corporation, and instead rearrange the loan as if it was from the shareholder. Bergman thus involved (1) a loan rearrangement, (2) no cash transfer at the time of the rearranged loans and (3) Bergman's own testimony that he was unsure about whether the rearranged loan was genuine when it was made. Bergman, 174 F.3d at 934. This Court suggested that Bergman's rearranged loans "could be viewed as merely a series of offsetting entries" because no cash was transferred at the time of the restructuring or rearranged loans. Id.

None of Bergman's factual problems are present in this case. This was not a loan restructuring case. There was an actual transfer of funds at the time the loans were executed. Don Oren treated the loans as genuine when

they were made and when he repaid the loans. Because this case presents none of the factual problems that were present in Bergman, the Orens submit that this Court must find that Don Oren's loans to HL and HS were genuine and must be respected. A close scrutiny of all the related party loans reveals that all the loans must be respected as genuine.

At the risk of being called preposterous again by the Commissioner (Comm. Br. 46), the Orens assert that District Court's opinion in Bergman is relevant and is instructive. Recall that in Bergman the District Court's interpretation of the facts assumed that the related party loan to the shareholder was genuine and that the shareholder intended to enforce his loan to the S corporation if required. Add. 45a, 47a. Under those assumed facts and other facts not challenged in Bergman, the District Court articulated the precise legal analysis that the Orens assert should apply in this case based on this record:

(1) When a shareholder transfers funds to an S corporation in exchange for a note, the source of funds is irrelevant under section 1366;

(2) There is no inference of a sham transaction simply because a taxpayer takes advantage of section 1366 and loans funds to an S corporation to create tax benefits;

(3) There is no sham transaction simply because the taxpayer controls the lending entity; and

(4) The economic outlay doctrine does not apply to direct loans in fact; not so, however, for purported loans, as in Bergman.

As reported in the Orens' Opening Brief in this case (p. 30), the Tax Court has ruled that the use of related party funds under section 1366 can create basis if properly executed. See Culnen v. Commissioner, 79 T.C.M. (CCH) 1933 (2000), rev'd and remanded on other grounds, 28 Fed. Appx. 116 (3d. Cir. 2002). The shareholder in the Culnen case did not possess a high degree of evidentiary support for his loans from his controlled corporation. Nonetheless the Tax Court recognized that even though the shareholder did not execute loan documents at the time, his bookkeeping adequately kept track of his borrowing from his controlled corporation on behalf of another S corporation for which he was claiming adjusted basis. The Tax Court reviewed the facts and concluded that the transfer of funds comported with the statutory requirement. Id. at 1937.

Once Don Oren established, that he made a direct loan where cash was transferred in exchange for a note where he borrowed the funds from a related party, he satisfied the form and economic substance of section 1366.

D. The Four Lending Transactions Had Economic Substance.

The determination of whether a shareholder makes an economic outlay for purposes of section 1366 is based on the facts and circumstances of each case. No case, however, has held that the flow of funds between related parties per se eliminates economic substance from a transaction. Nonetheless the Commissioner's argument relies primarily on stating that the circular flow of funds per se lacks economic substance.

Regardless of whether the Commissioner argues "substance over form" or "step transaction" he has failed to provide a case that directs this Court to ignore all the facts supporting the genuineness of the lending transactions. The Tax Court erroneously ignored the contemporaneous execution of loan documents with the actual transfer of funds, ignored the parties' adherence to the terms of the loan documents (annual payment of interest, repayment of loans, etc.), ignored the ownership interests of the minority shareholders in Dart, ignored the approval of the loans by the independent third party bank, and ignored the recognition of the loans in the Financial Statements by the independent auditors.

The Commissioner has not provided any factual challenge to the legally enforceable notes that were executed at the time that cash was transferred to HL and HS. If the notes were legally enforceable and fully

recourse, under what circumstances could HL and HS ignore them without any effect to Don Oren as shareholder? The answer is none. The same is true for all the notes. Each party to the lending transaction had at their disposal assets to satisfy the notes. There is nothing in the Code that requires a lender to loan money only to some one who cannot repay him or her. See Gefen v. Commissioner, 87 T.C. 1471, 1503 (1986). Such an argument is absurd. Don Oren's decision to loan money to HL and HS was clearly based on his legal right to claim adjusted basis in the companies for their direct indebtedness to him pursuant to section 1366.

The Commissioner repeatedly attempts to characterize the lending transactions as providing a circular series of identical offsetting obligations without economic substance. The facts prove otherwise. The lending bank, First Bank, did approve loans to Don Oren on the condition that Don Oren make equal loans to another Dart company, in this case HL and HS. Add. 7a. First Bank did not require that HL or HS in turn loan the money back to Dart. The Commissioner conceded that Dart required funds for operational purposes. Comm. Br. 13 n.7, 43-44. Dart obviously looked to HL and HS as a legitimate source of funds. The loaning of funds from HL and HS to Dart was not legally required by First Bank.

Furthermore, at the time that HL and HS loaned funds to Dart, the Financial Statements reveal that both HL and HS already owed money to Dart for other unrelated advances. App. 166-211. The auditors did not offset this pre-existing debt between HL/HS and Dart. The new loans at issue were recorded in the books and recognized by the auditors in their gross amounts. Id. Under those conditions, if HL or HS had made a demand for funds from Dart, Dart would have had an opportunity to offset that demand with the pre-existing debt owed to Dart.

But there was no such pre-existing debt between Don Oren and Dart. If Dart demanded payment from Don Oren, Don Oren had no legal right to offset his debt to Dart. Besides, if HL and HS had already been paid by Dart by offsetting other pre-existing debt, HL and HS might not have the funds to repay Don Oren. Thus, the risk that Don Oren would have to repay Dart without the benefit of the funds that he loaned to HL and HS was real and not protected by any loss-limiting arrangement as argued by the Commissioner under section 465(b)(4). The facts in the record establish that this case did not involve a circular series of offsetting obligations as the Commissioner suggests and as the Tax Court erroneously concluded.

The Commissioner complains that the lending transactions lack economic substance because the loans had generous terms, such as the

375-day demand period or lack of security. But the presence of favorable terms in the notes does not eliminate the legal obligations that resulted from execution of the notes.

The Commissioner complains that HL and HS did not retain the funds loaned by Don Oren for use in their businesses, but instead loaned the funds to Dart. As Don Oren testified, the line of credit from the First Bank provided for a zero balance account that required Dart and its related companies to pay interest daily on amounts charged against its line of credit. Add. 8a n.4. HL and HS simple exercised sound business judgment to loan the funds to Dart and thereby reduce the overall interest charges to Dart, HL, HS and other related companies. This is not evidence of lack of economic substance, rather it is evidence supports the prudent manner in which Don Oren conducted business.

What is the best evidence that a party can show that he treated a loan as valid? Repayment. All the parties repaid all the loans in 1996. Another significant phase in a series of perfectly legal transactions imbued with legal significance. Both the Tax Court and the Commissioner, however, take this unambiguous evidence that all the parties adhered to the terms of the loans and tries to turn the evidence into part of the tax scheme. For example, the Commissioner complains that the parties did not avail themselves of the

375-day period for repayment after demand. The Commissioner's complaints attempt to distort the parties' overall respect for the loan documents. Early repayment of a note can hardly be seen as evidence of a lack of economic substance.

Furthermore, both the Tax Court and the Commissioner improperly suggest that the parties' loan repayments in 1996 was evidence of a sham transaction because it was motivated in part by the Commissioner's 1996 administrative challenge to the lending transactions. Don Oren testified that in 1993 he could have invested personal funds in HL and HS had he so chosen. Add. 8a n.3. His decision to do so in 1996 was a business decision and does not lack merit because it was based in part on his decision to minimize potential tax exposure.

II. DON OREN WAS PERSONALLY LIABLE TO DART FOR THE FOUR LOANS FROM DART.

The plain language of section 465 limits loss deductions to taxpayers who are "at risk" for any money borrowed that was contributed to a business activity, such as leasing. Don Oren personally borrowed funds from Dart for the funds that he contributed, i.e., loaned, to HL and HS. HL and HS lease trailers and tractors, respectively. The loans from Dart were recourse. There was no agreement to limit, or restrict in any way, Don Oren's repayment obligations to Dart. Thus, Don Oren was personally liable, i.e., at risk, for

his debt to Dart. Section 465(b)(4), therefore, does not limit his loss deductions for HL and HS.

The Commissioner's failure to offer any factual challenge to the bona fide lending transactions discussed above regarding section 1366 is also fatal to his argument under section 465. Many of the same facts that the Orens established that supported the genuineness of the lending transactions under section 1366 also support that Don Oren was at risk on his loans from Dart where he contributed those loaned funds to HL and HS.

The Commissioner has conceded that he must establish under section 465(b)(4) that the lending transactions constituted an arrangement that eliminated any risk to Don Oren from the leasing business of HL and HS. But the record shows that Don Oren was personally liable on his notes from Dart. There was no agreement or arrangement or insurance that protected Don Oren from the risk of loss on the business activity at issue here, the leasing business of HL and HS.

From a purely mechanical point of view, the lending transactions in this case contained only one of the many attributes of typical sale-leaseback cases reviewed by the courts under section 465(b)(4), i.e., the circular transfer of funds between related parties. All the other facts are distinguishable. First, all the notes in this case were recourse. There were no

guarantees. Cash actually changed hands (and banks). The parties had the economic means to repay the notes when they were made. The notes were actually executed contemporaneously with the transfer of cash. The notes were respected by the minority shareholders. The notes were approved by First Bank. The notes were audited by Deloitte & Touche. The notes were repaid in 1996.

Now we examine the critical facts present in the typical sale-leaseback cases that were not present in the Orens lending transactions. First, the Orens' lending transactions did not rely on mere offsetting accounting entries. The loan repayments were not structured to offset identical lease payments. In fact the lending transactions had no factual or legal relationship to the leasing income of HL and HS. This fact alone distinguishes the Orens' lending transactions from the sale-leaseback cases. In the sale-leaseback cases, the taxpayers designed an arrangement to protect themselves from risk of loss. They implemented a circular flow of identical and offsetting loan and lease payments by using accounting entries because none, or few, of the parties had the financial wherewithal to actually repay any of the notes without receiving the identical, offsetting lease payments. The amounts borrowed were inextricably connected to the lease income by use of a circular set of offsetting obligations. No such connection between the

lending transactions and lease payments for HL and HS is present in this case.

Accordingly, the Tax Court erred when it found that the Orens' lending transactions were indistinguishable from sale-leaseback transactions based primarily, if not solely, on the circular transfer of funds between the related parties. The sale-leaseback cases cited by the Tax Court stand for the general proposition that courts will look to the substance of an arrangement and will be guided by economic reality. See Moser v. Commissioner, 914 F.2d 104 (8th Cir. 1990); American Principals Leasing Corp. v. United States, 904 F.2d 477 (9th Cir. 1990); Levien v. Commissioner, 103 T.C. 120 (1994), aff'd, 77 F.3d 497 (11th Cir. 1996); Thornock v. Commissioner, 94 T.C. 439 (1990).

A fair reading of Moser and American Principals reveals that this Court and the Ninth Circuit actually analyzed the substance of the transactions and did not rely on only one factor. This Court and the Ninth Circuit found that there was no realistic possibility of economic loss where the parties designed a circular scheme because the parties individually lacked independent means to repay the limited recourse notes without receiving the benefit of the identical and offsetting lease payment. Moser, 914 F.2d at 1049; American Principals, 904 F.2d at 483. In these two cases,

circularity was used as a mechanism to avoid the necessity of exchanging cash between the parties. Clearly the lack of any cash changing hands was paramount in finding that the parties lack independent means to repay the notes. Moser, 914 F.2d at 1049; American Principals, 904 F.2d at 483.

Finally, the Orens have explained that throughout the years in question the truckload carrier services and the leasing business of HL and HS were subject to economic risks like any other business. As in investor in these businesses, Don Oren, just like the minority shareholders in Dart, were never guaranteed protection from losses in the businesses. The Orens' expert witness provided additional evidence of the Orens' business strategies that succeeded in the highly competitive trucking business. App. 277-305. The expert witness report was completely ignored by the Tax Court and the Commissioner never even cross-examined the expert at trial. But then such oversight is explained by the Tax Court's reliance on the circular flow of funds as the sine qua non for finding that the lending transactions amounted to a stop-loss arrangement.

CONCLUSION

Taxpayers should be able to rely on the law as written in section 1366 and section 465. The law is clear. The Orens request that this Court reverse the Tax Court decision on both grounds.

Respectfully submitted,

Myron L. Frans
FAEGRE & BENSON LLP
2200 Wells Fargo Center
90 South Seventh Street
Minneapolis, Minnesota 55402-3901
(612) 766-6906

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 03-1448

Donald G. Oren and Beverly J. Oren,

Appellants,

vs.

Commissioner of Internal Revenue,

Appellee.

ON APPEAL FROM THE UNITED STATES TAX COURT

REPLY BRIEF FOR THE APPELLANTS DONALD G. OREN AND BEVERLY J. OREN

CERTIFICATE OF COMPLIANCE

The undersigned, counsel of record for Appellant certifies, pursuant to Fed. R. App. P. 32(a)(7)(B) - (C) and Eighth Circuit Rule 28A(c) - (d), that this brief complies with the following requirements:

(i) The number of words in the brief is 5,624**;**

(ii) The name and version of the word processing software used to prepare the brief was Microsoft Word 97**;**

(iii) The diskette containing the full text of this brief has been scanned for viruses using the Trend Office Scan – Corporate Edition 5.

Myron L. Frans
FAEGRE & BENSON LLP
2200 Wells Fargo Center
90 South Seventh Street
Minneapolis, Minnesota 55402-3901
(612) 766-6906

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 03-1448

Donald G. Oren and Beverly J. Oren,

Appellants,

vs.

Commissioner of Internal Revenue,

Appellee.

ON APPEAL FROM THE UNITED STATES TAX COURT

REPLY BRIEF FOR THE APPELLANTS DONALD G. OREN AND BEVERLY J. OREN

Proof Of Service

This is to certify that two (2) copies of the Reply Brief and a diskette for the Appellants Donald G. Oren and Beverly J. Oren (with the Certificate of Compliance), were served on the following person by Certified U.S. Mail this 9th day of June, 2003:

Ms. Andrea R. Tebbets
Tax Division/Appellate Section
U.S. Department of Justice
P.O. Box 502
Washington, D.C. 20044

This is to certify that ten (10) copies of the Reply Brief and a diskette for the Appellants Donald G. Oren and Beverly J. Oren (with the Certificate of Compliance), were filed with the Clerk of this Court by Certified U.S. Mail this 9th day of June, 2003:

Mr. Michael E. Gans
Clerk of Court of the United States
Court of Appeals for the Eighth Circuit
Thomas F. Eagleton Court House
Room 24.329
111 S. 10th Street
Saint Louis, MO 63102

Myron L. Frans
FAEGRE & BENSON LLP
2200 Wells Fargo Center
90 South Seventh Street
Minneapolis, Minnesota 55402-3901
(612) 766-6906

M1:999196.02